

SCHMITT INDUSTRIES INC  
Form 10-Q  
April 10, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

February 29, 2012 For the quarterly period ended: February 29, 2012

Or

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from: To:

Commission File Number: 000-23996

**SCHMITT INDUSTRIES, INC.**

(Exact name of registrant as specified in its charter)

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**Oregon**  
(State or other jurisdiction of  
incorporation or organization)

**93-1151989**  
(IRS Employer  
Identification Number)

**2765 NW Nicolai Street, Portland, Oregon 97210-1818**  
(Address of principal executive offices) (Zip Code)

**(503) 227-7908**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant has (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its Corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares of each class of common stock outstanding as of March 30, 2012

Common stock, no par value 2,990,910

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements**

**SCHMITT INDUSTRIES, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

	February 29, 2012	May 31, 2011
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 2,730,113	\$ 2,760,506
Accounts receivable, net of allowance of \$21,467 and \$21,580 at February 29, 2012 and May 31, 2011, respectively	1,878,659	1,831,811
Inventories	4,425,378	4,146,408
Prepaid expenses	124,091	166,779
Income taxes receivable	17,830	
	9,176,071	8,905,504
<b>Property and equipment</b>		
Land	299,000	299,000
Buildings and improvements	1,723,273	1,582,936
Furniture, fixtures and equipment	1,240,447	1,199,143
Vehicles	121,835	129,330
	3,384,555	3,210,409
Less accumulated depreciation and amortization	(1,966,181)	(1,876,234)
	1,418,374	1,334,175
<b>Other assets</b>		
Intangible assets, net	1,247,298	1,349,583
<b>TOTAL ASSETS</b>	<b>\$ 11,841,743</b>	<b>\$ 11,589,262</b>
<b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 572,825	\$ 841,416
Accrued commissions	298,170	308,396
Accrued payroll liabilities	226,961	116,129
Other accrued liabilities	301,325	163,940
Income taxes payable		2,073
<b>Total current liabilities</b>	<b>1,399,281</b>	<b>1,431,954</b>
<b>Stockholders equity</b>		
Common stock, no par value, 20,000,000 shares authorized, 2,972,355 and 2,895,635 shares issued and outstanding at February 29, 2012 and May 31, 2011, respectively	10,207,252	9,943,910
Accumulated other comprehensive loss	(276,242)	(226,581)

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Retained earnings	511,452	439,979
<b>Total stockholders equity</b>	10,442,462	10,157,308
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 11,841,743</b>	<b>\$ 11,589,262</b>

The accompanying notes are an integral part of these financial statements.

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**Table of Contents****SCHMITT INDUSTRIES, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****FOR THE THREE AND NINE MONTHS ENDED FEBRUARY 29 and 28, 2012 AND 2011****(UNAUDITED)**

	Three Months Ended February 29 and 28,		Nine Months Ended February 29 and 28,	
	2012	2011	2012	2011
Net sales	\$ 3,156,497	\$ 2,920,121	\$ 10,104,207	\$ 8,239,035
Cost of sales	1,616,534	1,611,615	5,389,802	4,401,932
Gross profit	1,539,963	1,308,506	4,714,405	3,837,103
Operating expenses:				
General, administration and sales	1,448,818	1,294,072	4,481,536	3,677,808
Research and development	91,842	198,534	197,698	420,474
Total operating expenses	1,540,660	1,492,606	4,679,234	4,098,282
Operating income (loss)	(697)	(184,100)	35,171	(261,179)
Other income (expense)	6,901	(3,806)	33,031	(3,972)
Income (loss) before income taxes	6,204	(187,906)	68,202	(265,151)
Provision (benefit) for income taxes	(6,417)	3,934	(3,271)	(1,578)
Net income (loss)	\$ 12,621	\$ (191,840)	\$ 71,473	\$ (263,573)
Net earnings (loss) per common share:				
Basic	\$ 0.00	\$ (0.07)	\$ 0.02	\$ (0.09)
Weighted average number of common shares, basic	2,939,281	2,894,922	2,910,401	2,894,842
Diluted	\$ 0.00	\$ (0.07)	\$ 0.02	\$ (0.09)
Weighted average number of common shares, diluted	2,964,892	2,894,922	2,937,019	2,894,842

The accompanying notes are an integral part of these financial statements.

**Table of Contents****SCHMITT INDUSTRIES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****FOR THE NINE MONTHS ENDED FEBRUARY 29 and 28, 2012 AND 2011****(UNAUDITED)**

	Nine Months Ended February 29 and 28,	
	2012	2011
<b>Cash flows relating to operating activities</b>		
Net income (loss)	\$ 71,473	\$ (263,573)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	256,723	257,991
Gain on disposal of property and equipment	(18,014)	
Stock-based compensation	149,278	28,563
Excess tax benefit from stock-based compensation		(114)
(Increase) decrease in:		
Accounts receivable	(58,885)	(711,065)
Inventories	(284,056)	(189,783)
Prepaid expenses	42,514	(18,809)
Income taxes receivable	(19,903)	2,584
Increase (decrease) in:		
Accounts payable	(266,891)	(29,208)
Other accrued liabilities	240,506	(32,373)
Net cash provided by (used in) operating activities	112,745	(955,787)
<b>Cash flows relating to investing activities</b>		
Purchase of property and equipment	(269,113)	(149,994)
Proceeds from sale of property and equipment	47,180	
Net cash used in investing activities	(221,933)	(149,994)
<b>Cash flows relating to financing activities</b>		
Proceeds from exercise of stock options	114,064	1,916
Excess tax benefit from stock-based compensation		114
Net cash provided by financing activities	114,064	2,030
<b>Effect of foreign exchange translation on cash</b>	<b>(35,269)</b>	<b>(7,800)</b>
<b>Decrease in cash and cash equivalents</b>	<b>(30,393)</b>	<b>(1,111,551)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>2,760,506</b>	<b>3,545,986</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 2,730,113</b>	<b>\$ 2,434,435</b>
<b>Supplemental Disclosure of Cash Flow Information</b>		
Cash paid (received) during the period for income taxes	\$ 16,632	\$ (4,059)

The accompanying notes are an integral part of these financial statements.





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## SCHMITT INDUSTRIES, INC.

## CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

## AND COMPREHENSIVE INCOME

FOR THE NINE MONTHS ENDED FEBRUARY 29, 2012

(UNAUDITED)

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total	Total comprehensive income
<b>Balance, May 31, 2011</b>	2,895,635	\$ 9,943,910	\$ (226,581)	\$ 439,979	\$ 10,157,308	
Stock options exercised	76,720	114,064			114,064	
Stock-based compensation		149,278			149,278	
Net income				71,473	71,473	\$ 71,473
Other comprehensive loss			(49,661)		(49,661)	(49,661)
<b>Balance, February 29, 2012</b>	2,972,355	\$ 10,207,252	\$ (276,242)	\$ 511,452	\$ 10,442,462	
<b>Comprehensive income, nine months ended February 29, 2012</b>						\$ 21,812

The accompanying notes are an integral part of these financial statements.

**Table of Contents****SCHMITT INDUSTRIES, INC.****NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS****Note 1:****SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES****Basis of Presentation**

The consolidated financial information included herein has been prepared by Schmitt Industries, Inc. (the Company or Schmitt) and its wholly owned subsidiaries. In the opinion of management, the accompanying unaudited Consolidated Financial Statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission and contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly its financial position as of February 29, 2012 and its results of operations and its cash flows for the periods presented. The consolidated balance sheet at May 31, 2011 has been derived from the Annual Report on Form 10-K for the fiscal year ended May 31, 2011. The accompanying unaudited financial statements and related notes should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended May 31, 2011. Operating results for the interim periods presented are not necessarily indicative of the results that may be experienced for the fiscal year ending May 31, 2012.

**Revenue Recognition**

The Company recognizes revenue for sales and billing for freight charges upon delivery of the product to the customer at a fixed and determinable price with a reasonable assurance of collection, passage of title to the customer as indicated by shipping terms and fulfillment of all significant obligations, pursuant to the guidance provided by Accounting Standards Codification ( ASC ) Topic 605. For sales to all customers, including manufacturer representatives, distributors or their third-party customers, these criteria are met at the time product is shipped. When other significant obligations remain after products are delivered, revenue is recognized only after such obligations are fulfilled. In addition, judgments are required in evaluating the credit worthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectability is reasonably assured.

**Financial Instruments**

The carrying value of all other financial instruments potentially subject to valuation risk (principally consisting of cash and cash equivalents, accounts receivable and accounts payable) also approximates fair value because of their short-term maturities.

**Note 2:****INVENTORY**

Inventory is valued at the lower of cost or market with cost determined on the average cost basis. Costs included in inventories consist of materials, labor and manufacturing overhead, which are related to the purchase or production of inventories. Write-downs, when required, are made to reduce excess inventories to their net realizable values. Such estimates are based on assumptions regarding future demand and market conditions. If actual conditions become less favorable than the assumptions used, an additional inventory write-down may be required. As of February 29, 2012 and May 31, 2011, inventories consisted of:

	Feb. 29, 2012	May 31, 2011
Raw materials	\$ 1,686,808	\$ 1,649,925
Work-in-process	1,228,798	892,541
Finished goods	1,509,772	1,603,942
	\$ 4,425,378	\$ 4,146,408



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### **Note 3:**

#### **LINE OF CREDIT**

In February 2012, the Company extended its bank line of credit secured by U.S. accounts receivable, inventories and general intangibles through March 1, 2014 and raised the lending limit from \$1.0 million to \$2.0 million. Interest is payable at the bank's prime rate (3.25% as of February 29, 2012) or LIBOR plus 2.0% (2.24% as of February 29, 2012). There were no outstanding balances on the line of credit at February 29, 2012 and May 31, 2011.

### **Note 4:**

#### **STOCK OPTIONS AND STOCK-BASED COMPENSATION**

Stock-based compensation includes expense charges for all stock-based awards to employees and directors granted under the Company's stock option plan. Stock-based compensation recognized during the period is based on the portion of the grant date fair value of the stock-based award that will vest during the period, adjusted for expected forfeitures. Compensation cost for all stock-based awards is recognized using the straight-line method. The Company uses the Black-Scholes option pricing model as its method of valuation for stock-based awards. The Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. These variables include, but are not limited to:

*Risk-Free Interest Rate.* The Company bases the risk-free interest rate on the implied yield currently available on U.S. Treasury issues with an equivalent remaining term approximately equal to the expected life of the award.

*Expected Life.* The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures.

*Expected Volatility.* The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of its common stock. The volatility factor the Company uses is based on its historical stock prices over the most recent period commensurate with the estimated expected life of the award. These historical periods may exclude portions of time when unusual transactions occurred.

*Expected Dividend Yield.* The Company does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero.

*Expected Forfeitures.* The Company uses relevant historical data to estimate pre-vesting option forfeitures. The Company records stock-based compensation only for those awards that are expected to vest.

The Company has computed, to determine stock-based compensation expense recognized for those options granted during the three and nine months ended February 29, 2012 and February 28, 2011, the value of all stock options granted using the Black-Scholes option pricing model. No stock options were issued during the nine months ended February 29, 2012 and February 28, 2011.

At February 29, 2012, the Company had a total of 301,056 outstanding stock options (221,056 vested and exercisable and 80,000 non-vested) with a weighted average exercise price of \$3.97. The Company estimates that a total of approximately \$50,000 will be recorded as additional stock-based compensation expense during the remainder of the year ending May 31, 2012 for all options that were outstanding as of February 29, 2012, but which were not yet vested.



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Outstanding Options			Exercisable Options		
Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (yrs)	Number of Shares	Weighted Average Exercise Price	
19,390	\$ 1.20	0.0	19,390	\$ 1.20	
41,666	2.30	2.3	41,666	2.30	
160,000	3.65	9.3	80,000	3.65	
5,000	5.80	3.7	5,000	5.80	
75,000	6.16	6.2	75,000	6.16	
301,056	3.97	6.8	221,056	4.08	

Options granted, exercised, and forfeited or canceled under the Company's stock option plan during the three and nine months ended February 29, 2012 are summarized as follows:

	Three Months Ended February 29, 2012		Nine Months Ended February 29, 2012	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding beginning of period	344,776	\$ 3.68	387,776	\$ 3.47
Options granted				
Options exercised	(43,720)	1.70	(76,720)	1.49
Options forfeited/canceled			(10,000)	3.65
Options outstanding February 29, 2012	301,056	3.97	301,056	3.97

**Note 5:****EPS RECONCILIATION**

	Three Months Ended February 29 and 28, 2012		Nine Months Ended February 29 and 28, 2011	
	2012	2011	2012	2011
Weighted average shares (basic)	2,939,281	2,894,922	2,910,401	2,894,842
Effect of dilutive stock options	25,611		26,618	
Weighted average shares (diluted)	2,964,892	2,894,922	2,937,019	2,894,842

Basic earnings (loss) per share is computed using the weighted average number of common shares outstanding. Diluted earnings (loss) per share is computed using the weighted average number of common shares outstanding, adjusted for dilutive incremental shares attributed to outstanding options to purchase common stock. Common stock equivalents for stock options are computed using the treasury stock method. In periods in which a net loss is incurred, no common stock equivalents are included since they are antidilutive and as such all stock options outstanding are excluded from the computation of diluted net loss in those periods. 68,057 potentially dilutive common shares from outstanding stock options have been excluded from diluted earnings (loss) per share for the three months ended February 28, 2011. 63,445 potentially dilutive common shares from outstanding stock options have been excluded from diluted earnings (loss) per share for the nine months ended February 28, 2011.

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### **Note 6:**

#### **INCOME TAXES**

The Company accounts for income taxes using the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax basis of assets and liabilities. Deferred tax assets are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Each year the Company files income tax returns in the various national, state and local income taxing jurisdictions in which it operates. These tax returns are subject to examination and possible challenge by the taxing authorities. Positions challenged by the taxing authorities may be settled or appealed by the Company. As a result, there is an uncertainty in income taxes recognized in the Company's financial statements in accordance with ASC Topic 740, which the Company adopted on June 1, 2007. The Company applies this guidance by defining criteria that an individual income tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements and provides guidance on measurement, de-recognition, classification, accounting for interest and penalties, accounting in interim periods, disclosure, and transition.

Other long-term liabilities related to tax contingencies were \$0 as of February 29, 2012 and May 31, 2011. Interest and penalties associated with uncertain tax positions are recognized as components of the Provision for income taxes. The liability for payment of interest and penalties was \$0 as of February 29, 2012 and May 31, 2011.

Several tax years are subject to examination by major tax jurisdictions. In the United States, federal tax years for Fiscal 2007 and after are subject to examination. In the United Kingdom, tax years for Fiscal 2006 and after are subject to examination. In Canada, tax years for 2005 and after are subject to examination. In the United States, returns related to an acquired subsidiary for the year ended October 31, 1994 and the final return for the period ended May 19, 1995 are also subject to examination.

#### **Effective Tax Rate**

The effective tax rate on consolidated net income was (4.8)% for the nine months ended February 29, 2012. The effective tax rate on consolidated net income differs from the federal statutory tax rate primarily due to the amount of income from foreign jurisdictions and certain expenses not being deductible for income tax reporting purposes offset by changes in the deferred tax valuation allowance and tax credits related to research and experimentation expenses. Management believes the effective tax rate for Fiscal 2012 will be approximately 5.7% due to the items noted above.

### **Note 7:**

#### **SEGMENTS OF BUSINESS**

The Company has two reportable business segments: dynamic balancing systems for the machine tool industry (Balancer) and laser-based and ultrasonic test and measurement systems (Measurement). The Company operates in three principal geographic markets: North America, Europe and Asia.

**Table of Contents****Segment Information**

	Three Months Ended February 29 and 28,			
	2012		2011	
	Balancer	Measurement	Balancer	Measurement
Gross sales	\$ 2,412,507	\$ 933,306	\$ 2,381,177	\$ 767,450
Intercompany sales	(181,924)	(7,392)	(218,712)	(9,794)
Net sales	\$ 2,230,583	\$ 925,914	\$ 2,162,465	\$ 757,656
Operating income (loss)	\$ 270,113	\$ (270,810)	\$ 45,819	\$ (229,919)
Depreciation expense	\$ 37,751	\$ 16,568	\$ 30,153	\$ 14,265
Amortization expense	\$	\$ 33,659	\$	\$ 40,562
Capital expenditures	\$ 1,098	\$ 7,027	\$ 82,014	\$ 37,063

	Nine Months Ended February 29 and 28,			
	2012		2011	
	Balancer	Measurement	Balancer	Measurement
Gross sales	\$ 7,786,463	\$ 3,038,822	\$ 6,186,738	\$ 2,612,904
Intercompany sales	(672,056)	(49,022)	(524,806)	(35,801)
Net sales	\$ 7,114,407	\$ 2,989,800	\$ 5,661,932	\$ 2,577,103
Operating income (loss)	\$ 422,444	\$ (387,273)	\$ 51,207	\$ (312,386)
Depreciation expense	\$ 105,099	\$ 50,648	\$ 91,989	\$ 44,318
Amortization expense	\$	\$ 100,976	\$	\$ 121,684
Capital expenditures	\$ 127,648	\$ 141,465	\$ 102,925	\$ 47,069

**Geographic Information-Net Sales by Geographic Area**

	Three Months Ended February 29 and 28,		Nine Months Ended February 29 and 28,	
	2012	2011	2012	2011
North America	\$ 2,014,834	\$ 1,545,547	\$ 5,937,212	\$ 4,379,732
Europe	217,241	191,402	831,363	744,562
Asia	866,227	1,134,600	2,967,373	2,838,879
Other markets	58,195	48,572	368,259	275,862
Total Net Sales	\$ 3,156,497	\$ 2,920,121	\$ 10,104,207	\$ 8,239,035



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	Three Months Ended February 29 and 28,			
	2012		2011	
	United States	Europe	United States	Europe
Operating income (loss)	\$ 4,969	\$ (5,666)	\$ (89,621)	\$ (94,479)
Depreciation expense	\$ 54,319	\$	\$ 44,418	\$
Amortization expense	\$ 33,659	\$	\$ 40,562	\$
Capital expenditures	\$ 8,125	\$	\$ 119,077	\$

	Nine Months Ended February 29 and 28,			
	2012		2011	
	United States	Europe	United States	Europe
Operating income (loss)	\$ (2,865)	\$ 38,036	\$ (131,690)	\$ (129,489)
Depreciation expense	\$ 155,747	\$	\$ 136,307	\$
Amortization expense	\$ 100,976	\$	\$ 121,684	\$
Capital expenditures	\$ 269,113	\$	\$ 149,994	\$

Note Europe is defined as the European subsidiary, Schmitt Europe, Ltd.

**Segment and Geographic Assets**

	February 29, 2012	May 31, 2011
Segment assets to total assets		
Balancer	\$ 5,192,481	\$ 5,284,244
Measurement	3,901,319	3,544,512
Corporate assets	2,747,943	2,760,506
<b>Total assets</b>	<b>\$ 11,841,743</b>	<b>\$ 11,589,262</b>
Geographic assets to long-lived assets		
United States	\$ 1,418,374	\$ 1,334,175
Europe		
<b>Total assets</b>	<b>\$ 1,418,374</b>	<b>\$ 1,334,175</b>
Geographic assets to total assets		
United States	\$ 11,196,469	\$ 10,882,569
Europe	645,274	706,693
<b>Total assets</b>	<b>\$ 11,841,743</b>	<b>\$ 11,589,262</b>

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Forward-Looking Statements**

This Quarterly Report filed with the SEC on Form 10-Q (the Report), including Management's Discussion and Analysis of Financial Condition and Results of Operations in this Item 2, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 regarding future events and the future results of Schmitt Industries, Inc. and its consolidated subsidiaries (the Company) that are based on management's current expectations, estimates, projections and assumptions about the Company's business. Words such as expects, anticipates, intends, plans, believes, sees, estimates and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors, including, but not limited to, those discussed in the Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Report as well as those discussed from time to time in the Company's other Securities and Exchange Commission filings and reports. In addition, such statements could be affected by general industry and market conditions. Such forward-looking statements speak only as of the date of this Report or, in the case of any document incorporated by reference, the date of that document, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Report. If we update or correct one or more forward-looking statements, investors and others should not conclude that we will make additional updates or corrections with respect to other forward-looking statements.

**RESULTS OF OPERATIONS****Overview**

Schmitt Industries, Inc. designs, manufactures and markets computer-controlled vibration detection and balancing equipment (the Balancer segment) to the worldwide machine tool industry and, through its wholly owned subsidiary, Schmitt Measurement Systems, Inc., precision laser-based surface measurement products, laser-based distance measurement products and ultrasonic measurement systems (the Measurement segment) for a variety of industrial applications worldwide. The Company sells and markets its products in Europe through its wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom. The Company is organized into two operating segments: the Balancer segment and the Measurement segment. The accompanying unaudited financial information should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended May 31, 2011.

SBS, SMS, Acuity, Xact and Lasercheck are registered trademarks owned by the Company.

For the three months ended February 29, 2012, total sales increased \$236,000, or 8.1%, to \$3.2 million from \$2.9 million for the three months ended February 28, 2011. For the nine months ended February 29, 2012, total sales increased \$1.9 million, or 22.6%, to \$10.1 million from \$8.2 million for the nine months ended February 28, 2011. Balancer segment sales focus on end-users, rebuilders and original equipment manufacturers of grinding machines primarily in North America, South America, Asia and Europe. Balancer segment sales increased \$68,000, or 3.2%, to \$2.2 million for the three months ended February 29, 2012 compared to \$2.2 million for the three months ended February 28, 2011. Balancer segment sales increased \$1.5 million, or 25.7%, to \$7.1 million for the nine months ended February 29, 2012 compared to \$5.7 million for the nine months ended February 28, 2011. The increases in this quarter and the first nine months of Fiscal 2012 in worldwide balancer sales are due to higher volumes of shipments as the worldwide automotive and manufacturing industries continue to recover from the global economic downturn. The Measurement segment product line consists of laser-based light-scatter products, distance measurement and dimensional sizing products and remote tank monitoring products. Total Measurement segment sales increased \$168,000, or 22.2%, to \$926,000 for the three months ended February 29, 2012 compared to \$758,000 for the three months ended February 28, 2011. Total Measurement segment sales increased \$413,000, or 16.0%, to \$3.0 million for the nine months ended February 29, 2012 compared to \$2.6 million for the nine months ended February 28, 2011. The increase is primarily due to higher volumes of shipments of laser-based light scatter surface measurement products, distance measurement and dimensional sizing products and remote tank monitoring products.

Operating expenses increased \$48,000, or 3.2%, to \$1.5 million for the three months ended February 29, 2012 from \$1.5 million for the three months ended February 28, 2011. Operating expenses increased \$581,000, or 14.2%, to \$4.7 million for the nine months ended February 29, 2012 from \$4.1 million for the nine months ended February 28, 2011.

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General, administration and sales expenses increased \$155,000, or 12.0%, to \$1.4 million for the three months ended February 29, 2012 from \$1.3 million for the same period in the prior year. General, administration and sales expenses increased \$804,000, or 21.9%, to \$4.5 million for the nine months ended February 29, 2012 from \$3.7 million for the nine months ended February 28, 2011. Research and development expenses decreased \$107,000, or 53.7%, to \$92,000 for the three months ended February 29, 2012 from \$199,000 for the three months ended February 28, 2011. Research and development expenses decreased \$223,000, or 53.0%, to \$198,000 for the nine months ended February 29, 2012 from \$420,000 for the nine months ended February 28, 2011. For the three months ended February 29, 2012, net income was \$13,000, or \$0.00 per fully diluted share, as compared to a net loss of \$192,000, or \$0.07 per fully diluted share, for the three months ended February 28, 2011. Net income was \$71,000, or \$0.02 per fully diluted share, for the nine months ended February 29, 2012 as compared to a net loss of \$264,000, or \$0.09 per fully diluted share, for the nine months ended February 28, 2011.

**Critical Accounting Policies**

There were no material changes in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended May 31, 2011.

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	Three Months Ended February 29 and 28,			
	2012		2011	
Balancer sales	\$ 2,230,583	70.7%	\$ 2,162,465	74.1%
Measurement sales	925,914	29.3%	757,656	25.9%
<b>Total sales</b>	<b>3,156,497</b>	<b>100.0%</b>	<b>2,920,121</b>	<b>100.0%</b>
Cost of sales	1,616,534	51.2%	1,611,615	55.2%
<b>Gross profit</b>	<b>1,539,963</b>	<b>48.8%</b>	<b>1,308,506</b>	<b>44.8%</b>
Operating expenses:				
General, administration and sales	1,448,818	45.9%	1,294,072	44.3%
Research and development	91,842	2.9%	198,534	6.8%
<b>Total operating expenses</b>	<b>1,540,660</b>	<b>48.8%</b>	<b>1,492,606</b>	<b>51.1%</b>
Operating loss	(697)	0.0%	(184,100)	-6.3%
Other income (expense)	6,901	0.2%	(3,806)	-0.1%
Income (loss) before income taxes	6,204	0.2%	(187,906)	-6.4%
Provision (benefit) for income taxes	(6,417)	-0.2%	3,934	0.1%
<b>Net income (loss)</b>	<b>\$ 12,621</b>	<b>0.4%</b>	<b>\$ (191,840)</b>	<b>-6.6%</b>

	Nine Months Ended February 29 and 28,			
	2012		2011	
Balancer sales	\$ 7,114,407	70.4%	\$ 5,661,932	68.7%
Measurement sales	2,989,800	29.6%	2,577,103	31.3%
<b>Total sales</b>	<b>10,104,207</b>	<b>100.0%</b>	<b>8,239,035</b>	<b>100.0%</b>
Cost of sales	5,389,802	53.3%	4,401,932	53.4%
<b>Gross profit</b>	<b>4,714,405</b>	<b>46.7%</b>	<b>3,837,103</b>	<b>46.6%</b>
Operating expenses:				
General, administration and sales	4,481,536	44.4%	3,677,808	44.6%
Research and development	197,698	2.0%	420,474	5.1%
<b>Total operating expenses</b>	<b>4,679,234</b>	<b>46.3%</b>	<b>4,098,282</b>	<b>49.7%</b>
Operating income (loss)	35,171	0.3%	(261,179)	-3.2%
Other income (expense)	33,031	0.3%	(3,972)	0.0%
Income (loss) before income taxes	68,202	0.7%	(265,151)	-3.2%
Benefit for income taxes	(3,271)	0.0%	(1,578)	0.0%
<b>Net income (loss)</b>	<b>\$ 71,473</b>	<b>0.7%</b>	<b>\$ (263,573)</b>	<b>-3.2%</b>

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Sales Sales in the Balancer segment increased \$68,000, or 3.2%, to \$2.2 million for the three months ended February 29, 2012 compared to \$2.2 million for the three months ended February 28, 2011. This increase is primarily due to

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higher unit sales volumes in North America and Europe offset by decreases in Asia during the third quarter of Fiscal 2012. North American sales increased \$322,000, or 37.2%, in the three months ended February 29, 2012 compared to the same period in the prior year. European sales increased \$14,000, or 9.0%, in the third quarter of Fiscal 2012 compared to the third quarter of Fiscal 2011. Sales in Asia decreased \$284,000, or 25.8%, for the three months ended February 29, 2012 as compared to the three months ended February 28, 2011. Sales in other regions of the world increased \$15,000, or 43.9%, in the third quarter of Fiscal 2012 as compared to the same quarter in the prior year. The increases in North America, Europe and other regions of the world are due primarily to higher volumes of shipments as the automotive and industrial markets continue to recover from the global economic downturn. The decrease in Asia is due to a slight softening in orders from this market as economic growth in China is slowing. The levels of demand for our Balancer products in any of these geographic markets cannot be forecasted with any certainty given current economic trends and the historical volatility experienced in this market.

Sales in the Balancer segment increased \$1.5 million, or 25.7%, to \$7.1 million for the nine months ended February 29, 2012 compared to \$5.7 million for the nine months ended February 28, 2011. This increase is primarily due to higher unit sales volumes in North America and Europe offset by a decrease in Asia during the first nine months of Fiscal 2012. North American sales increased \$1.3 million, or 57.0%, in the nine months ended February 29, 2012 compared to the same period in the prior year. European sales increased \$34,000, or 6.0%, in the first nine months of Fiscal 2012 compared to the first nine months of Fiscal 2011. Sales in Asia decreased \$70,000, or 2.6%, for the nine months ended February 29, 2012 as compared to the nine months ended February 28, 2011. Sales in other regions of the world increased \$190,000, or 219.1%, in the first nine months of Fiscal 2012 as compared to the same period in the prior year. These increases or decreases across all markets are due primarily to the same reasons for the three months ended February 29, 2012 noted above.

Sales in the Measurement segment increased \$168,000, or 22.2%, to \$926,000 in the three months ended February 29, 2012 compared to \$758,000 in the three months ended February 28, 2011. Sales of laser-based distance measurement and dimensional sizing products increased \$121,000, or 18.3%, in the three months ended February 29, 2012 as compared to the same period in the prior year primarily due to the higher volume of shipments in the current fiscal year resulting from the economic recovery in the commercial and industrial markets. Sales of remote tank monitoring products increased \$54,000 to \$69,000 during the third quarter of Fiscal 2012 as compared to the same period in the prior year. Sales of laser-based light-scatter surface measurement products decreased \$7,000, or 8.3%, in the three months ended February 29, 2012 as compared to the same period in the prior year primarily due to lower volumes of shipments. Future sales of laser-based measurement products cannot be forecasted with any certainty given the historical volatility experienced in this market.

Sales in the Measurement segment increased \$413,000, or 16.0%, to \$3.0 million in the nine months ended February 29, 2012 compared to \$2.6 million in the nine months ended February 28, 2011. Sales of light-scatter laser-based surface measurement products in the nine months ended February 29, 2012 increased \$186,000, or 38.6%, as compared to the same period in the prior year primarily due to the sale of a surface roughness measurement product and higher volumes of shipments of Measurement products generally. Sales of laser-based distance measurement and dimensional sizing products increased \$124,000, or 6.1%, in the nine months ended February 29, 2012 as compared to the same period in the prior year. Sales of remote tank monitoring products increased \$102,000 to \$155,000 during the first nine months of Fiscal 2012 as compared to the same period in the prior year.

**Gross margin** Gross margin for the three months ended February 29, 2012 increased to 48.8% as compared to 44.8% for the three months ended February 28, 2011. Gross margin for the nine months ended February 29, 2012 increased to 46.7% as compared to 46.6% for the nine months ended February 28, 2011. These increases in gross margin are primarily a result of reducing the costs of inventory components and by changes in the product sales mix shifting toward higher margin products.

**Operating expenses** Operating expenses increased \$48,000, or 3.2%, to \$1.5 million for the three months ended February 29, 2012 as compared to \$1.5 million for the three months ended February 28, 2011. General, administrative and selling expenses increased \$155,000, or 12.0%, for the three months ended February 29, 2012 as compared to the same period in the prior year primarily due to higher personnel costs, higher sales and marketing expenses in connection with higher sales, higher maintenance and repair expenses and higher stock-based compensation offset by lower commission expenses. Research and development expenses decreased \$107,000, or 53.7%, as compared to the same period in the prior year primarily due to lower material costs associated with new product development related to existing product lines.

Operating expenses increased \$581,000, or 14.2%, to \$4.7 million for the nine months ended February 29, 2012 as compared to \$4.1 million for the nine months ended February 28, 2011. General, administrative and selling expenses increased \$804,000, or 21.9%, for the nine months ended February 29, 2012 as compared to the same period in the

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prior year primarily due to higher commissions related to the increase in sales, higher personnel costs, higher sales and marketing expenses in connection with higher sales, higher maintenance and repair expenses, higher patent-related expenses and higher stock-based compensation. Research and development expenses decreased \$223,000, or 53.0%, as compared to the same period in the prior year primarily due to lower material costs associated with new product development related to existing product lines. Management expects to incur higher sales and marketing expenses going forward as a result of enhanced business development efforts in both the Balancer and Measurement segments, particularly regarding the SBS and Xact product lines.

**Other income** Other income consists of interest income, foreign currency exchange gain (loss) and other income (expense). Interest income was \$0 and \$1,000 for the three months ended February 29, 2012 and February 28, 2011, respectively. Interest income was \$1,000 and \$3,000 for the nine months ended February 29, 2012 and February 28, 2011, respectively. Interest income has decreased due to lower interest rates and decreased cash balances. Foreign currency exchange gains (losses) were \$6,000 and \$(5,000) for the three month periods ended February 29, 2012 and February 28, 2011, respectively. Foreign currency exchange gains (losses) were \$14,000 and \$(7,000) for the nine months ended February 29, 2012 and February 28, 2011, respectively. The increase in the gain (loss) is primarily due to the weakening of foreign currencies against the US dollar during the first nine months of Fiscal 2012. Other income consisted of an \$18,000 gain on the sales of fixed assets for the nine months ended February 29, 2012.

**Income tax provision** The Company's effective tax rate on consolidated net income was (4.8)% for the nine months ended February 29, 2012. The Company's effective tax rate on consolidated net income differs from the federal statutory tax rate primarily due to the amount of income from foreign jurisdictions and certain expenses not being deductible for income tax reporting purposes offset by changes in the deferred tax valuation allowance and tax credits related to research and experimentation expenses. Management believes the effective tax rate for Fiscal 2012 will be 5.7% due to the items noted above.

**Net income** Net income increased to \$13,000, or \$0.00 per diluted share, for the three months ended February 29, 2012 as compared to a net loss of \$192,000, or \$0.07 per diluted share, for the three months ended February 28, 2011. Net income increased due primarily to higher sales and the related gross profit, higher gross margin and lower research and development expenses offset by higher general, administrative and sales expenses during the three months ended February 29, 2012. Net income increased to \$71,000, or \$0.02 per diluted share, for the nine months ended February 29, 2012 as compared to a net loss of \$264,000, or \$0.09 per diluted share, for the nine months ended February 28, 2011. Net income increased due primarily to higher sales and the related gross profit and lower research and development expenses offset by higher general, administrative and sales expenses during the nine months ended February 29, 2012.

**LIQUIDITY AND CAPITAL RESOURCES**

The Company's working capital increased \$303,000 to \$7.8 million as of February 29, 2012 from \$7.5 million as of May 31, 2011. Cash and cash equivalents decreased \$30,000 to \$2.7 million as of February 29, 2012 from \$2.8 million as of May 31, 2011.

Cash provided by operating activities totaled \$113,000 for the nine months ended February 29, 2012 as compared to cash used in operating activities of \$956,000 for the nine months ended February 28, 2011. The increase was primarily due to an increase in net income, less of an increase in accounts receivable, an increase in accrued liabilities and higher stock-based compensation offset by an increase in inventories and a decrease in accounts payable.

At February 29, 2012, the Company had inventories of \$4.4 million as compared to \$4.1 million at May 31, 2011. The increase in inventories of \$279,000 was due to the increase in sales and anticipated demand in the first nine months of Fiscal 2012. At February 29, 2012, total current liabilities decreased \$33,000 to \$1.4 million as compared to \$1.4 million at May 31, 2011. The decrease was primarily due to a decrease in accounts payable associated with the timing of payments offset by an increase in accrued payroll liabilities and customer deposits.

During the nine months ended February 29, 2012, net cash used in investing activities was \$222,000, which consisted of additions to property and equipment offset by proceeds received from the sale of property and equipment. Additions to property and equipment consisted primarily of building improvements, computer equipment and vehicles.

During the nine months ended February 29, 2012, net cash provided by financing activities was \$114,000, which consisted of proceeds from the exercise of stock options.

The Company has a \$2.0 million bank line of credit agreement secured by U.S. accounts receivable, inventories and general intangibles. Interest is payable at the bank's prime rate (3.25% as of February 29, 2012), or LIBOR plus 2.0% (2.24% as of February 28, 2012), and the agreement expires on March 1, 2014. There were no outstanding balances on the line of credit at February 29, 2012 and May 31, 2011.





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We believe that our existing cash and cash equivalents combined with the cash we anticipate generating from operating activities and our available line of credit and financing available from other sources will be sufficient to meet our cash requirements for the foreseeable future. We do not have any significant commitments nor are we aware of any significant events or conditions that are likely to have a material impact on our liquidity or capital resources.

### **Business Risks**

The following are important factors that could cause actual results or events to differ materially from those contained in any forward-looking statements made by or on behalf of the Company (see the forward-looking statements disclaimer at the beginning of Item 2 in this Report). In addition, the risks and uncertainties described below are not the only ones that the Company faces. Unforeseen risks could arise and problems or issues that the Company now views as minor could become more significant. If the Company were unable to adequately respond to known or unknown risks, the Company's business, financial condition or results of operations could be materially adversely affected. In addition, the Company cannot be certain that any actions taken to reduce known or unknown risks and uncertainties will be effective.

*The general economic conditions and uncertainties may adversely affect the Company's business, operating results and financial condition*

The Company's operations and performance depend significantly on worldwide economic conditions, particularly in the manufacturing and automotive sectors, and their impact on levels of capital investment, which have deteriorated significantly in the past and may become depressed, or be subject to further deterioration. Economic factors that could adversely influence demand for the Company's products include uncertainty about global economic conditions leading to reduced levels of investment, customers' and suppliers' access to credit, unemployment and other macroeconomic factors affecting commercial and industrial spending behavior.

The past distress in the financial markets and global economy has resulted in reduced liquidity and a tightening of credit markets. As a result of these conditions, the Company could experience several potential adverse effects, including the inability of customers to obtain credit to finance purchases of the Company's products, the insolvency of customers resulting in reduced sales and bad debts, and the insolvency of key suppliers resulting in product development and production delays.

*The Company's primary markets are volatile and unpredictable*

The Company's business depends on the demand for our various products in a variety of commercial and industrial markets. In the past, demand for our products in these markets has fluctuated due to a variety of factors, some of which are beyond our control, including: general economic conditions, both domestically and internationally, the timing, number and size of orders from, and shipments to, our customers as well as the relative mix of those orders and variations in the volume of orders for a particular product line in a particular quarter.

*The introduction of the Xact tank monitoring system may not become commercially viable and satisfy expected demand*

In May 2009, the Company announced the introduction of the Xact tank monitoring system for measuring fill levels of industrial liquefied propane tanks and communicating that data via satellite to a secure web site. Although the initial acquisition and further development of the Xact product has negatively impacted recent operating results, the product should allow the Company to enter new measurement markets and is expected to add sales and profits to the Company in future years. However, the introduction of the Xact product may not be successful, anticipated market demand for the product may not materialize and additional product or market opportunities may not be identified and developed and brought to market in a timely and cost-effective manner. Also, the Company may not be able to meet the manufacturing requirements of large orders in a timely and cost-effective manner. All of this could continue to negatively impact future operating results and result in large and immediate write-offs of recorded intangible asset balances.

*New products may not be developed to satisfy changes in consumer demands*

The failure to develop new technologies, or react to changes in existing technologies, could materially delay development of new products, which could result in decreased revenues and a loss of market share to competitors. Financial performance depends on the ability to design, develop, manufacture, assemble, test, market and support new products and enhancements on a timely and cost-effective basis. New product opportunities may not be identified and developed and brought to market in a timely and cost-effective manner. Products or technologies developed by other

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companies may render products or technologies obsolete or noncompetitive, or a fundamental shift in technologies in the product markets could have a material adverse effect on the Company's competitive position within historic industries.

### *Failure to protect intellectual property rights could adversely affect future performance and growth*

Failure to protect existing intellectual property rights may result in the loss of valuable technologies or paying other companies for infringing on their intellectual property rights. The Company relies on patent, trade secret, trademark and copyright law to protect such technologies. There is no assurance any of the Company's U.S. patents will not be invalidated, circumvented, challenged or licensed to other companies.

### *Competition is intense and the Company's failure to compete effectively would adversely affect its business*

Competition in the markets for the Company's products is intense. The speed with which companies can identify new applications for the Company's various technologies, develop products to meet those needs and supply commercial quantities at low prices to those new markets are important competitive factors. The principal competitive factors in the Company's markets are product features, performance, reliability and price. Many of the Company's competitors have greater financial, technical, research and development and marketing resources. No assurance can be given that the Company will be able to compete effectively in the future, and the failure to do so would have a material adverse effect on the Company's business, financial condition and results of operations.

### *Production time and the overall cost of products could increase if any of the primary suppliers are lost or if a primary supplier increased the prices of raw materials*

Manufacturing operations depend upon obtaining adequate supplies of raw materials on a timely basis. The results of operations could be adversely affected if adequate supplies of raw materials cannot be obtained in a timely manner or if the costs of raw materials increased significantly.

### *Fluctuations in quarterly and annual operating results make it difficult to predict future performance*

Quarterly and annual operating results are likely to fluctuate in the future due to a variety of factors, some of which are beyond management's control. As a result of quarterly operating fluctuations, it is important to realize quarter-to-quarter comparisons of operating results are not necessarily meaningful and should not be relied upon as indicators of future performance.

### *The Company may not be able to reduce operating costs quickly enough if sales decline*

Operating expenses are generally fixed in nature and largely based on anticipated sales. However, should future sales decline significantly and rapidly, there is no guarantee management could take actions that would further reduce operating expenses in either a timely manner or without seriously impacting the operations of the Company.

### *The Company maintains a significant investment in inventories in anticipation of future sales*

The Company believes it maintains a competitive advantage by shipping product to its customers more rapidly than its competitors. As a result, the Company has a significant investment in inventories. These inventories are recorded using the lower-of-cost or market method, which requires management to make certain estimates. Management evaluates the recorded inventory values based on customer demand, market trends and expected future sales and changes these estimates accordingly. A significant shortfall of sales may result in carrying higher levels of inventories of finished goods and raw materials thereby increasing the risk of inventory obsolescence and corresponding inventory write-downs. As a result, the Company may not carry adequate reserves to offset such write-downs.

### *Future success depends in part on attracting and retaining key management and qualified technical and sales personnel*

Future success depends on the efforts and continued services of key management, technical and sales personnel. Significant competition exists for such personnel, and there is no assurance that key technical and sales personnel can be retained or that other highly qualified technical and sales personnel as required can be attracted, assimilated and retained. There is also no guarantee that key employees will not leave and subsequently compete against the Company. The inability to attract and retain key personnel could adversely impact the business, financial condition and results of operations.

### *Changes in the effective tax rate may have an adverse effect on the Company's results of operations*

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The Company's future effective tax rate may be adversely affected by a number of factors including: the jurisdictions in which profits are determined to be earned and taxed; the resolution of issues arising from future potential tax audits with various tax authorities; changes in the valuation of our deferred tax assets and liabilities; adjustments to estimated taxes upon finalization of various tax returns; increases in expenses not deductible for tax purposes; changes in available tax credits; changes in stock-based compensation expense; changes in tax laws or the interpretations of such tax laws and changes in generally accepted accounting principles.

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*Changes in securities laws and regulations have increased and will continue to increase Company expenses*

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules promulgated by the Securities and Exchange Commission, have increased and will continue to increase Company expenses as the Company devotes resources to ensure compliance with all applicable laws and regulations. In addition, the NASDAQ Capital Market, on which the Company's common stock is listed, has also adopted comprehensive rules and regulations relating to corporate governance. These laws, rules and regulations have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices. The Company may be required to hire additional personnel and use outside legal, accounting and advisory services to address these laws, rules and regulations. The Company also expects these developments to make it more difficult and more expensive for the Company to obtain director and officer liability insurance in the future, and the Company may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, the Company's board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which would adversely affect the Company.

*The Company faces risks from international sales and currency fluctuations*

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. International sales are subject to a number of risks, including: the imposition of governmental controls; trade restrictions; difficulty in collecting receivables; changes in tariffs and taxes; difficulties in staffing and managing international operations; political and economic instability; general economic conditions; and fluctuations in foreign currencies. No assurances can be given that these factors will not have a material adverse effect on future international sales and operations and, consequently, on business, financial condition and results of operations.

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### **Item 3. Quantitative and Qualitative Disclosures about Market Risk Interest Rate Risk**

The Company did not have any derivative financial instruments as of February 29, 2012. However, the Company could be exposed to interest rate risk at any time in the future and, therefore, employs established policies and procedures to manage its exposure to changes in the market risk of its marketable securities.

The Company's interest income and expense are most sensitive to changes in the general level of U.S. and European interest rates. In this regard, changes in U.S. and European interest rates affect the interest earned on the Company's interest bearing cash equivalents and short term investments. The Company has a variable rate line of credit facility with a bank but there was no outstanding balance as of February 29, 2012. Also, there is no other long-term obligation whose interest rates are based on variable rates that may fluctuate over time based on economic changes in the environment. Therefore, at this time, the Company is not subject to interest rate risk on outstanding interest bearing obligations if market interest rates fluctuate and does not expect any change in the interest rates to have a material effect on the Company's results from operations.

### **Foreign Currency Risk**

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. The Company operates a subsidiary in the United Kingdom and acquires certain materials and services from vendors transacted in foreign currencies. Therefore, the Company's business and financial condition is sensitive to currency exchange rates or any other restrictions imposed on their currencies. For the three months ended February 29, 2012 and February 28, 2011, results of operations included gains (losses) on foreign currency translation of \$6,000 and \$(5,000), respectively. For the nine months ended February 29, 2012 and February 28, 2011, results of operations included gains (losses) on foreign currency translation of \$14,000 and \$(7,000), respectively.

### **Item 4. Controls and Procedures Evaluation of Disclosure Controls and Procedures**

As of February 29, 2012, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the Exchange Act). Based on the evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this Report, the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed in the Company's Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives, and management necessarily is required to use its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

### **Changes in Internal Control Over Financial Reporting**

There has been no change in the Company's internal control over financial reporting that occurred during the Company's fiscal quarter ended February 29, 2012 that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting.

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**PART II OTHER INFORMATION**

**Item 6. Exhibits**

Exhibit	Description
3.1	Second Restated Articles of Incorporation of Schmitt Industries, Inc. (the Company). Incorporated by reference to Exhibit 3(i) to the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 1998.
3.2	Second Restated Bylaws of the Company. Incorporated by reference to Exhibit 3(ii) to the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 1998.
4.1	See exhibits 3.1 and 3.2 for provisions of the Articles of Incorporation and Bylaws defining the rights of security holders.
10.1	Amendment No. 1 to Loan Agreement between the Company and Bank of America, N.A. dated February 28, 2012.
31.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document *
101.SCH	XBRL Taxonomy Extension Schema Document *
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document *
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document *
101.LAB	XBRL Taxonomy Extension Label Linkbase Document *
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document *

\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SCHMITT INDUSTRIES, INC.

(Registrant)

Date: April 10, 2012

/s/ Wayne A. Case  
Wayne A. Case, Chairman of the Board and Chief Executive Officer